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Up Front

Opinion: How M&A Is Remaking Aerospace

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Orbital ATK

Five years after the inflection marked by the Great Recession's bottom and Iraq War's end, the market for mergers and acquisitions in aerospace and defense is heating up and taking shape. At this halfway point through 2015, the value of transactions consummated and announced is approaching $30 billion, a torrid pace roughly twice the trailing 10-year average. The year's transactions have put a resounding punctuation on three corporate development strategies that are sculpting a first wave in the restructuring of the A&D industry for this age of austerity, and they are also indicating what may drive a second wave. The long-awaited restructuring is at hand, even if the economic and business logic it expresses is defying conventional expectations of how it would unfold.

Bolt-on Growth. Alcoa's announcement in March of its agreement to acquire RTI International Metals is only the latest in a firmly established corporate development strategy whose logic could not be more straightforward: Gain capacity and capabilities with which to deliver the decade-long backlog of orders for large commercial airliners that have been flowing into Seattle and Toulouse since the end of the Great Recession. Alcoa's $1.5 billion purchase of RTI, a downstream titanium specialist, is actually the company's third instance of this strategy since last November, when it closed the acquisition of U.K.-based Firth Rixson. Of course, the Alcoa-RTI deal only punctuates a trend line that runs back to the 2010 merger of Triumph and Vought and includes this wave's centerpiece, the $18 billion acquisition of Goodrich by United Technologies in 2012, plus General Electric's purchase of Avio Aero in 2013 and, not least, a five-year succession of nearly two dozen acquisitions by Precision Castparts that has featured its absorption of such stalwart brands as Primus, Heroux-Devtek, Timet and ADI.

Focus the Business Model. Two of this year's biggest corporate-development announcements—UTC's intent to divest Sikorsky and Computer Sciences Corp.'s plan to separate its commercial and public sector businesses—each serve to confirm a second distinct strategy, the logic of which involves trading growth for profitability by narrowing portfolios around a more uniform business model. As best illustrated in CSC's announcement, the rationale for certain expressions of this strategy organizes coherence around common customer-types, a motive underlying the spin-off of Exelis from ITT in 2011, the separation of SAIC from Leidos in 2013 and the spin-off of Vista Outdoors from ATK just ahead of its merger with Orbital Sciences Corp. this past February. However, as indicated by the UTC-Sikorsky situation, still another expression of this focus strategy strives for business-model coherence by sorting for dissimilar risk-reward characteristics, a motive underlying the spin-off of shipbuilder Huntington Ingalls Industries from Northrop Grumman in 2011 as well as the separation of services specialist Engility from L-3 Communications in 2012 and this year's announcement that BAE Systems Inc. is weighing the divestiture of a $1.5 billion collection of its information and technical services business units.

Consolidate the Mid-Tier. The year's two marquee transactions—the merger of Orbital Sciences with ATK and Harris Corp.'s acquisition of Exelis—exemplify the third corporate-development strategy that is shaping this first wave of restructuring. The logic of these transactions is explained by that traditional expression: opportunistic accumulation of like-scale and complementary scope to improve the efficiency of operations and capitalizations. Among other transactions preceding Orbital ATK and Harris along this trend line were Gencorp-Aerojet's acquisition of Pratt & Whitney Rocketdyne in 2013, Textron's of Beechcraft in 2014, and Engility's acquiring of DRC (2013) and TASC (2015). A similar motivation is also on display—albeit less boldly—in the defense-electronics segment, where savvy small-cap firms are rolling up scale and scope: See Analog Devices, which last year acquired Hittite Microwave for $2 billion; Ultra Electronics, whose announcement this month of its acquisition of Kratos Electronic Products Div. (nee Herley) highlights a steady diet of opportunistic buying; and Teledyne, which is quietly scoring small-scale deals at a Precision Castparts-like pace.

The Next Wave. It is worth noting that the large-cap prime contractors of this industry, which one would expect to lead the wave, have stayed largely out of the water. That may be about to change. The coincidence in April of Defense Secretary Ashton Carter's foray to Silicon Valley with Raytheon's announcement of a $1.5 billion investment to control the commercial cybersecurity company Websense strikes me as a leading indicator of a new expression in corporate-development strategy marking the start of a second wave. In that it violates the (Norm) Augustine rule against diversification and tests the many income investors in RTN, Raytheon's move is undeniably bold. But the resonance it finds in Carter's call for reengagement of the commercial technology base in national security suggests that boldness may be rooted in a solemn calculation that others also are contemplating. Indeed, lurking among the footnotes to 10-K filings by several defense primes for the recent year are several small acquisitions that gain them new, if modest, exposure to civil-government and commercial customers. Among these transactions are the 2014 acquisitions of energy-sector companies S.M. Stoller and Universal Pegasus by Huntington Ingalls and Lockheed Martin's purchases, also last year, of Sun Catalytix, an energy-storage venture, and Amor Group, which provides information technology solutions to the energy, transport and public services sectors.


Credit: Orbital ATK

The structure of A&D that will result from these post-2010 corporate-development strategies will comprise a more varied grouping of company types and competition dynamics than exists now among the collection of firms that emerged from the post-Cold War restructuring. There will remain room for the pure-play behemoth, but that space will be smaller and the player's scope will be narrower. Other large companies will organize to leverage their capacities across a more diverse range of products and customers. And among them will be more companies rooted in the business practices and technology bases of the commercial/civil sphere.

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